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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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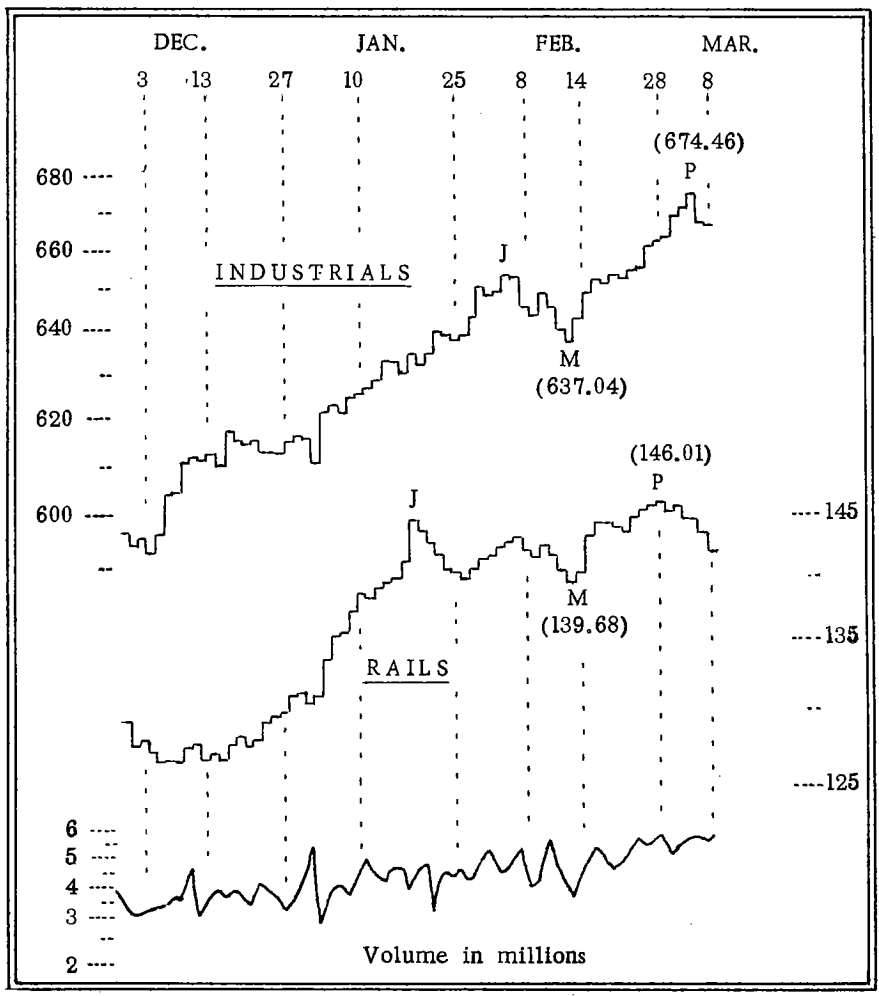
PRICE MOVEMENT On February 24 the Rail Average bettered its January 18 high of 144.89 (point J - see chart). That penetration confirmed the previous penetration by the Industrial Average through its own J point. Because of this confirmation the normal expectation was for a further and perhaps substantial rise in both Averages. The Rail bettering of J did spark a further rally in Industrials, yet there was little or no "follow-through" in the Rails themselves.

For five consecutive days (following the Rail penetration of J) the carrier Average held within easy striking distance of the all-important 146.56 secondary high. On February 28 Rails actually bettered the 146.56 level on an intra-day basis, only to retreat near the close. From March 1 to March 6 the two Averages diverged (to the accompaniment of heavy volume). March 6 saw Industrials establish a 1961 peak of 674.46 (P), but Rails closed lower on the day. On March 7 Industrials lost 7.20 points as both Averages finally got "in gear" on the downside. On March 8 volume rose to a whopping 5.91 million shares as Industrials dropped .99, Rails 1.38. Subscribers are again cautioned against drawing conclusions based on the penetration of a single Average. Many important reversals have been signalled as follows: (a) one Average penetrates a significant point, (b) the other Average stubbornly refuses to confirm. Current points of importance are at M and P (marked on chart).

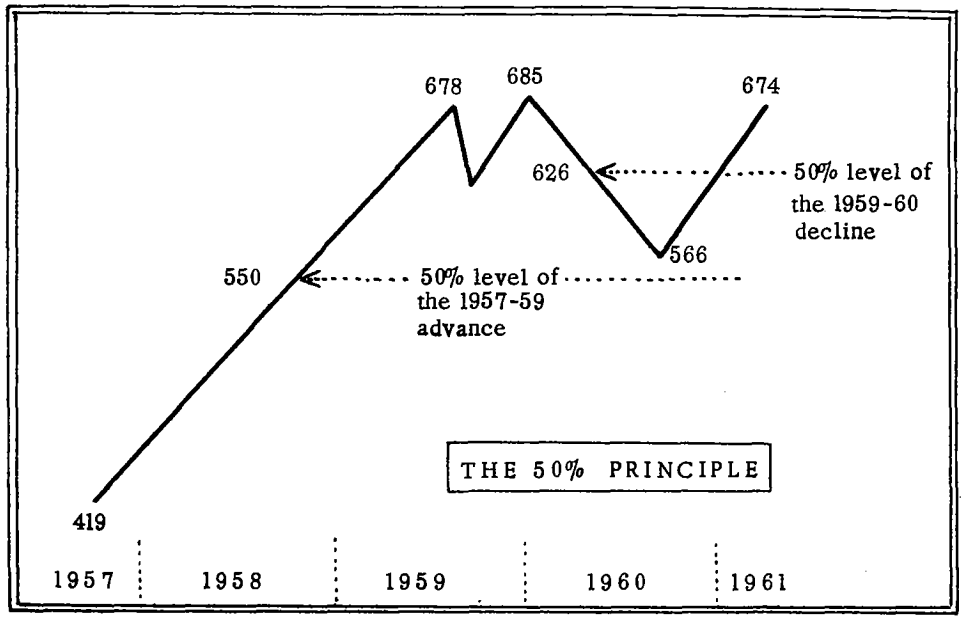


Any forthcoming rally which could advance the Rail Average above P (146.01) would almost certainly take the carriers through the 146.56 high as well. Such a penetration would provide the bull signal discussed in the last few Letters. Conversely, if the two Averages turn down and violate the nearby M points (Industrials 637.04, Rails 139.68) on increasing volume, the implication would be that the secondary trend has turned bearish. As stated in the last Letter under TACTICS, if the M points are approached, and if one or both Averages can hold above these levels as volume dries up, traders will then have an advantageous spot in which to take on speculative commitments.

DOW'S 50% PRINCIPLE In August, 1960, a Special Study of Dow's 50% Principle was mailed to subscribers. That study drew attention to the halfway or 50% level (550) of the entire 1957-59 Industrial advance (419.79 to 685.47). The market "topped" in

July, 1959, but on the subsequent bear market decline Industrials stubbornly refused to violate the halfway (550) level of the 1957-59 advance. Under the 50% Principle, this performance had to be viewed constructively. Letter 130 (January 16, 1960) again reviewed the implications of the 50% Principle, and the accompanying chart (brought up to date in this issue) was included.

The chart pictured Industrials persistently holding above the 50% or 550 level. It also drew attention to the fact that Industrials, after refusing to violate 550, had then advanced above the halfway point (626) of the entire bear market decline (685.47 to 566.05). Under the 50% Principle the way had been paved for a further advance which could approach the former bull market high of 685.47.



Since Letter 130 the market has continued its advance, and Industrials have moved into the vicinity of the old bull market high (the recent peak was 674.46). Dow's 50% Principle has thus fulfilled its forecasting mission, and there is only one thing it can tell us over the foreseeable future. If an extended decline should occur from this area, and if, on that decline, Industrials can hold above the halfw. level (620) of the advance since the lows (566 to 674), conditions would then be favorable for another advance to or above the recent high. Conversely, if a decline should violate the 620 level, the odds would then favor an approach to or a penetration of the 566.05 bear market low.

1957 AND NOW One of the things that can be said with absolute certainty about the stock market is that nobody has ever figured out a system to "beat" it. "Any thinking man," wrote Rhea, "will readily realize that if the Dow Theory were infallible, or if even one or two men could always interpret its implications correctly, there would soon be no speculation in stocks."

Veteran market practitioners, almost by definition, have discarded the concept of "perfection" as applied to their investing or trading operations. They know that profitable market procedure implies making as many right moves as possible while attempting to limit losses on the inevitable mistakes. All market knowledge is empirical; we learn by what went before. This alone removes stock market technology from the "exact science" category. At best the study of the price movement is a combination of tactics, strategy and probability.

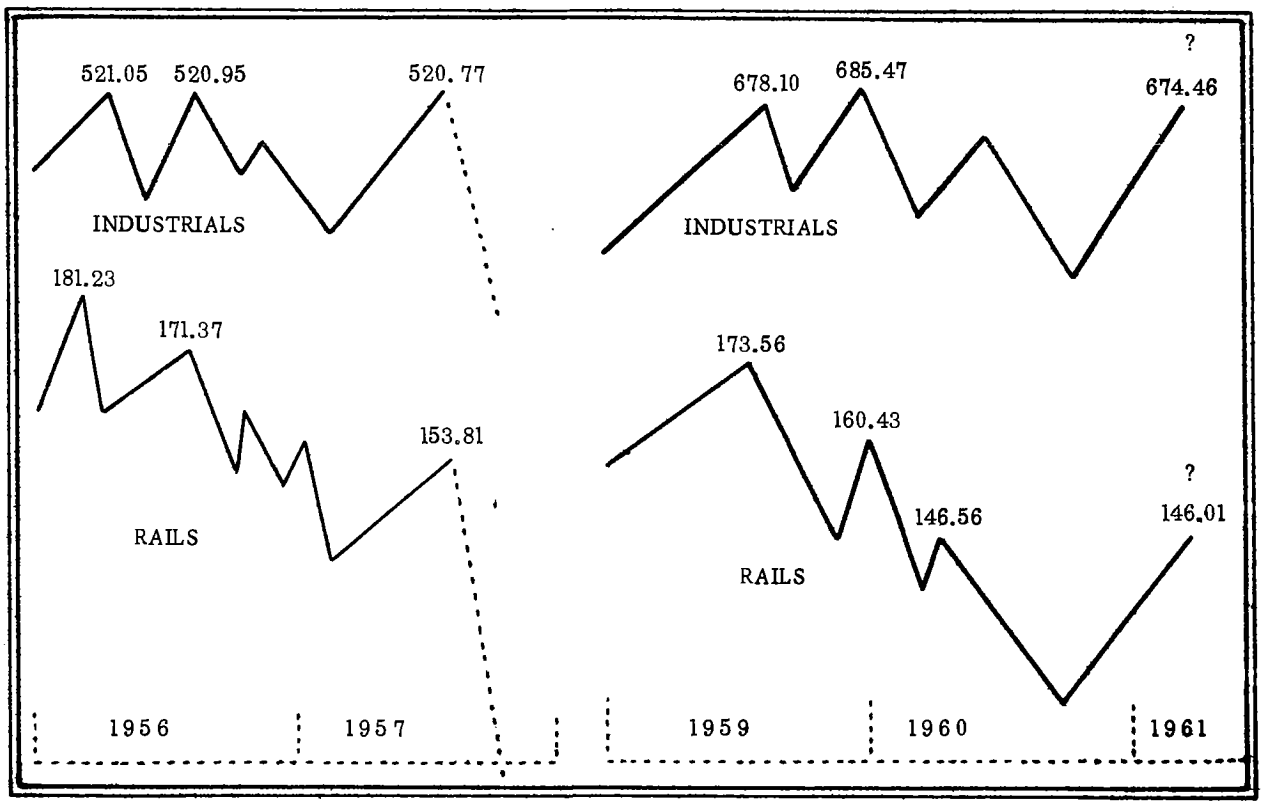
The question then arises -- when is a man operating correctly in the market? Some claim that the successful market practitioner is the one who is on "the right side" of every major swing. Rhea believed that the successful investor is the man who can go through a complete bull and bear swing and come out ahead. Personally, I have always leaned towards Rhea's definition because this definition does not imply that one need always be invested, and it makes a greater allowance for safety and "insurance". Many veteran traders or investors will withdraw completely from the market when they are perplexed; they know that the market will always be there, and that each new year or so is bound to produce a substantial swing one way or the other.

The current situation provides an excellent "tactical problem" for the veteran student. This statement can best be understood if we compare the price pattern of the last eighteen

months with the price pattern of 1956-57. In 1956 Industrials struck a peak of 521.05 in April, while Rails touched a corresponding peak of 181.23 (see chart). A reaction followed and on the next rise Industrials established a second peak of 520.95, Rails 171.37. A second substantial reaction occurred, which lasted to February, 1957. From the February lows a third advance carried Industrials to 520.77, Rails to 153.81. In other words, during 1956-57 three Industrial advances terminated in the 520 area, while Rails formed a series of descending peaks (181.23, 171.37 and 153.81). The situation was obviously a case of continued non-confirmation by Rails. From the standpoint of the Dow Theory, the danger signals were flying. On the retreat from the July, 1957 peaks, Industrials lost 100 points, Rails lost 58 points.

Today's situation makes a most interesting comparison. During the July-August, 1959 period, Industrials recorded a high of 678.10, Rails a peak of 173.56 (see chart). Following a reaction, Industrials touched a new peak of 685.47, while Rails established a lower peak of 160.43. Another severe decline followed (during which the bear signal was given). An advance began in October, 1960, which by last week had taken Industrials back to the 670-80 area, Rails to 146.01. This means that since 1959, Industrials have entered the 670-80 area on three occasions, but on each rise Rails have recorded successively lower peaks (173.56, 160.43 and 146.01). If both Averages turn down from current levels the price structure will contain elements of danger at least comparable to July, 1957 -- plus the following additional factors: (1) a bear market signal was given in March, 1960 (and has not since been retracted); (2) volume at and near the recent highs has surpassed anything seen in 28 years.

Of course, the fascinating part of the whole situation is that amazingly similar patterns may appear in the price structure, yet no one can be certain that history will repeat. If both Averages turn down from this area we may witness (1) a slight decline, (2) a 1/3 to 2/3 correction of the advance since the lows, (3) a sell-off comparable to or much worse than 1957. Bulls are betting that the Rails will shortly hurdle the 146.56 point, and that Industrials will continue through the 685.47 high. Bears have already protected themselves, and are now interested spectators. From the standpoint of trading tactics, however, a good case can be made for taking profits here and buying back if Rails better 146.56. The few points lost would have to be put down as the cost of "Insurance" against 1957's repeating itself.



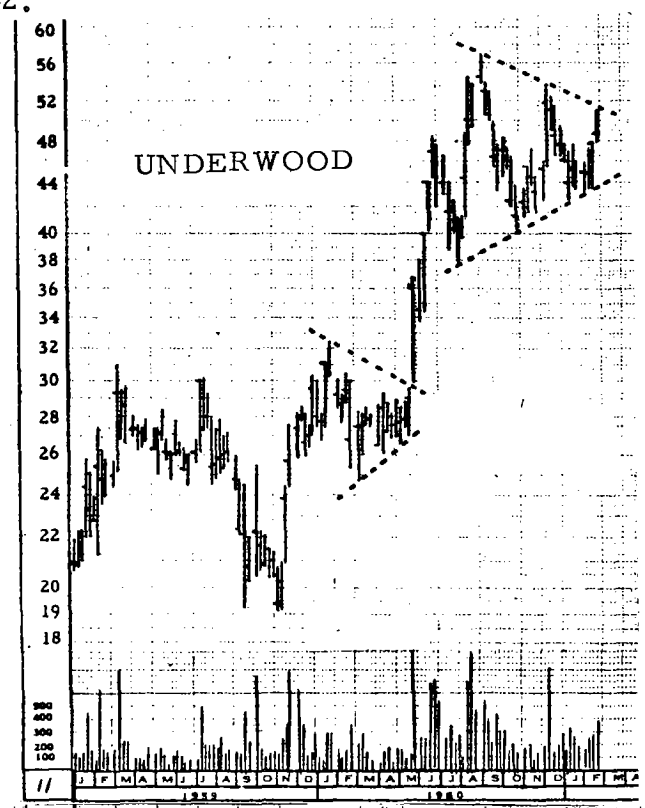
STOCKS A few spectacular formations have presented themselves on the weekly charts of Individual stocks. Bendix has formed an emense descending triangle. Such formations are suggestive of informed distribution. Note that the stock has been "picked-up" on three separate occasions in the 56 area, but on each successive rally the sellers were willing to settle for lower prices (lower tops). The most recent peak was at 72. The stock looks weak and in a position for shorting, with the stipulation that shorts be covered on any reversal and subsequent "breakout" above 73. The downside completion of the triangle would come on a violation of 56.

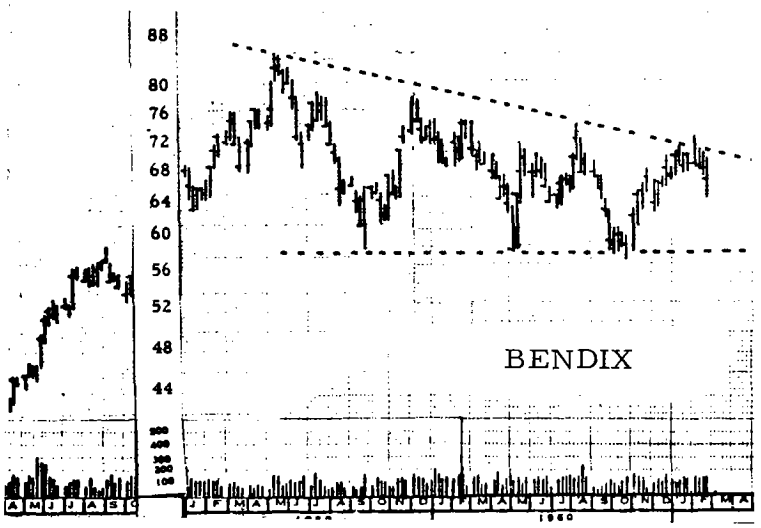
Underwood formed a symmetrical triangle in early 1960, then broke-out violently to the upside. A second spectacular symmetrical triangle has now formed. It is in the nature of symmetrical triangles that they do not give prior hints as to which way the break is coming. The final penetration provides the answer. The short position in Underwood was 50 thousand in October, 1960. It has dropped steadily to a February, 1961 total of 27 thousand. This alone constitutes technical deterioration. Upper penetration point in Underwood is 53, lower range for short selling is 42.

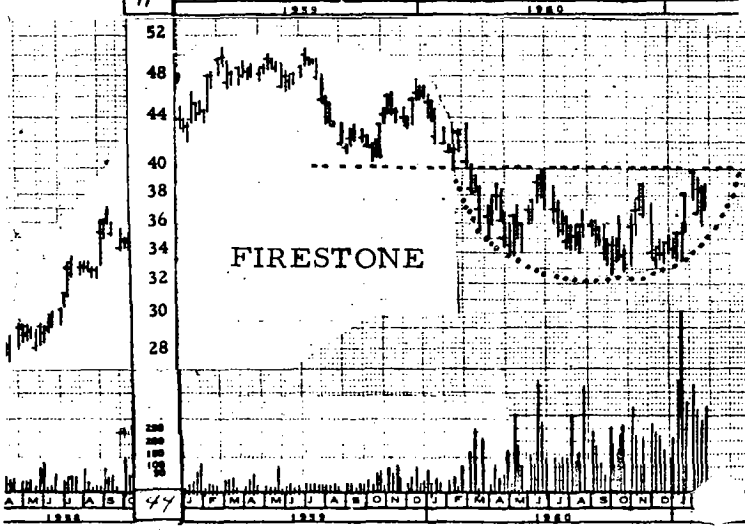
Firestone, after "topping" in 1959, has now formed a large "rounding bottom". The stock broke down completely when the important base at 40 was broken in early 1960. Note that the 40 level has now become the resistance point on the upside. The stock could be bought if it rises above 40 on impressive volume.

Avco was discussed last week. It subsequently broke to the upside on huge volume. This is an example of what happens when an important resistance point is bettered and a large short position is forced to scramble for "cover". The February short total in Avco was 93 thousand (!) against a January total of 27 thousand.

(Written Thursday, March 9th - 2 P.M.)







Charts courtesy of Traders Research, Box 6185, Lambert Airport, Missouri